Controlling loan quality: the management of non-performing loan portfolios in Kenya

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Abstract:

The traditional function of commercial banks is to accept deposits and extend credits. These two areas continue to be the mainstay of commercial banking even today. The banking function is an intermediary role between depositors (savers) and borrowers. The money used to extend credit to a large extent belongs to the depositors. Taking savers money and lending it to borrowers works quite well for all the parties until the loan becomes non-performing. A loan is said to be performing when it is being repaid according to the terms agreed upon. On the other hand, if the loan is not being serviced as required, it is said to be Non-performing. The loan may be in arrears and in addition inadequately secured. Where there is Non-Repayment of borrowed funds at widespread or significant levels there will be a devastating effect not only on the borrowers but also on the depositor, the banking Institution and the country at large. In Kenya the lack of sufficient specialized knowledge and skills and inadequate credit appraisal necessary for correct and expeditious credit decisions contributes to eventual emergence of bad debts. The financial statements, which the credit officer is supposed to analyze and base his decisions on, are prepared mostly on tax management considerations and not necessarily on the prudential principles of financial management. As a result, credit appraisal becomes an academic exercise, decision-making is uncertain, and the precious public money is at stake. Arising out of lack of skillful management of NPAs, Banks have collapsed, the economic growth has deteriorated, and borrowing institutions have gone under, bank customers have suffered and in the process lost their meager savings. The collapse of Banks due to NP As, has often lead to the multiplier effect, leading to a run on other Banks, particularly those directly linked to the collapsed Institution, loss of jobs, loss of public trust and confidence as well as public apathy.